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The Law Commission

Working Paper No 61

Penalty Clauses and Forfeiture of Monies Paid

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The Law Commission would be grateful for comments on this Working Paper before 1 December 1975.

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HER MAJESTY'S STATIONERY OFFICE
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ISBN 0 11 730092 6

THE LAW COMMISSION

WORKING PAPER No. 61

First Programme, Item I

LAW OF CONTRACT

PENALTY CLAUSES AND FORFEITURE OF MONIES PAID

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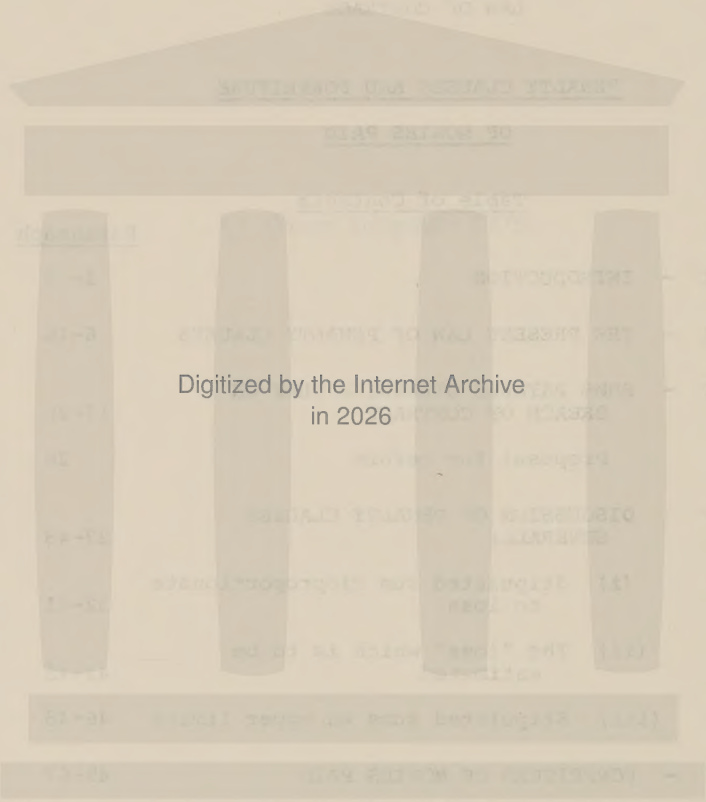

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PENALTY CLAUSES AND FORFEITURE OF MONIES PAID

PART I - INTRODUCTION

1. In our First Programme[1] we recommended that the law of contract be examined with a view to codification, and in our First Annual Report, 1965-1966[2], we stated that our intention was not merely to reproduce the existing law but to reform as well.

2. After much work had been done towards the preparation of a draft contract code, we came to the conclusion that the publication of such a code, however fully annotated, would not be the best way of directing public attention to particular aspects of the law of contract which might be in need of amendment or of promoting examination and discussion of those aspects in depth.[3]

3. Work on the production of a contract code has, therefore, been suspended and we now intend to publish a series of working papers on particular aspects of the English law of contract with a view to determining whether, and if so what, amendments of general principle are required. This will be in line with our method of dealing with most subjects and has the advantage of concentrating public discussion on particular problems.

4. This is one of several working papers which we expect to publish to initiate consideration of a number of aspects of the general principles of the law of contract. It deals with

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1. Law Com. No. 1 (1965), Item I.
2. Law Com. No. 4 (1966), para. 31.
3. Eighth Annual Report, 1972-1973, Law Com. No. 58 (1973), paras. 3-5.

problems arising out of the concept of liquidated damages and penalties and related questions, in particular the forfeiture of deposits and other monies paid under contract.

5. The law on penalty clauses in the States belonging to the Council of Europe has recently engaged the attention of the European Committee on Legal Co-operation. At its request the International Institute for the Unification of Private Law (Unidroit) prepared a study of the law on the subject in the 14 member States of the Council of Europe and of the difficult problems which would be involved in harmonizing the relevant but divergent rules. This has now led to the establishment at Strasbourg of a committee of experts composed of representatives from each member State "to draw up an international instrument, which might take the form of a convention providing for a uniform law, with a view to harmonizing the internal laws of member States in the field of penalty clauses in civil law." The committee held its first meeting in October 1974, the United Kingdom representatives being a member of the Scottish Law Commission and an official of the Law Commission. Despite the terms of reference, it is by no means certain that it will prove possible to reconcile the differences of approach of the various legal systems to a degree sufficient to enable a comprehensive convention to be drafted. Other possibilities might be a mere recommendation falling short of a binding set of rules or an instrument or recommendation relating only to penalty clauses connected with international contracts. The views expressed on the proposals contained in this working paper will be fully taken into account in considering the United Kingdom attitude to this European initiative.

PART II - THE PRESENT LAW OF PENALTY CLAUSES

6. A contract may provide for the payment of a sum of money by one party to another in the event of the former's breach of contract. Whether deriving their authority from the

common law, equity, or statute[4] the courts took the power to decide whether or not the agreed sum was payable, and the modern law became established during the nineteenth century.

7. The foundation of the present law is the distinction between "liquidated damages", which are recoverable, and a "penalty", which is irrecoverable. The law is generally taken to have been authoritatively expounded by Lord Dunedin in Dunlop Pneumatic Tyre Co. Ltd. v. New Garage and Motor Co. Ltd.[5] Although his statement of principles is well known it is convenient to set out here the propositions which he deduced from the decisions (referred to in the footnotes):

> "1. Though the parties to a contract who use the words 'penalty' or 'liquidated damages' may prima facie be supposed to mean what they say, yet the expression used is not conclusive. The Court must find out whether the payment stipulated is in truth a penalty or liquidated damages....
>
> 2. The essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine convenanted pre-estimate of damage.[6]
>
> 3. The question whether a sum stipulated is penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged of as at the time of the making of the contract, not as at the time of the breach.[7]
>
> 4. To assist this task of construction various tests have been suggested, which if applicable

4. See McGregor on Damages (13th ed., 1972), paras. 328-329.
5. [1915] A.C. 79, 86-88 (H.L.).
6. Clydebank Engineering and Shipbuilding Co. Ltd. v. Don Jose Ramos Yzquierdo y Castaneda [1905] A.C. 6.
7. Public Works Commissioner v. Hills [1906] A.C. 368, and Webster v. Bosanquet [1912] A.C. 394.

to the case under consideration may prove helpful, or even conclusive. Such are:

(a) It will be held to be penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.[8]

(b) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid.[9] This though one of the most ancient instances is truly a corollary to the last test....

(c) There is a presumption (but no more) that it is penalty when 'a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage'[10]....

(d) It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties.[11]"

8. Although Lord Dunedin affirmed the view that "the essence of a penalty is a payment of money stipulated as in terrorem of the offending party" this probably gives little or no guidance in distinguishing between a penalty and liquidated damages. The law of contract itself has a coercive force, and there must be not infrequent cases where the threat or fear of an action for damages itself operates as a spur to perform

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8. Illustration given by Lord Halsbury in Clydebank case, above.

9. Kemble v. Farren (1829) 6 Bing. 141. We propose to consider in a separate working paper the supposed rule that damages (otherwise than in the form of interest) cannot be recovered for failure to pay a sum of money.

10. Lord Watson in Lord Elphinstone v. Monkland Iron and Coal Co. Ltd. (1886) 11 App. Cas. 332.

11. Clydebank case, above, per Lord Halsbury at p. 11; Webster v. Bosanquet, above, per Lord Mersey at p. 398.

rather than to break the contract.[12] Moreover, a sum may be classed as a penalty even if it is smaller than the amount of damages that would be payable,[13] and conversely liquidated damages may be recoverable even though they are clearly in excess of any loss that would be compensated by damages[14] (a circumstance that may be known before breach, so that the liquidated damages would operate in terrorem). Lord Radcliffe has said that "... I do not myself think that it helps to identify a penalty, to describe it as in the nature of a threat 'to be enforced in terrorem'... it obscures the fact that penalties may quite readily be undertaken by parties who are not in the least terrorised by the prospect of having to pay them and yet are, as I understand it, entitled to claim the protection of the court when they are called upon to make good their promises."[15] The real and substantial point made in the second of Lord Dunedin's propositions is, no doubt, that the essence of liquidated damages is "a genuine convenanted pre-estimate of damage": the intention is to provide for reasonable compensation and nothing more.

9. Lord Dunedin's first proposition, although making the point that the term used is not conclusive,[16] indicated that "the parties to a contract who use the words 'penalty' or 'liquidated damages' may prima facie be supposed to mean what

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12. "Now, all such agreements, whether the thing be called penalty or be called liquidate damage, are in intention and effect what Professor Bell calls 'instruments of restraint,' and in that sense penal. But the clear presence of this element does not in the least degree invalidate the stipulation." - Clydebank case, above, per Lord Robertson at p. 19.

13. Wall v. Rederiaktiebolaget Luggude [1915] 3 K.B. 66; Watts, Watts and Co. Ltd. v. Mitsui and Co. Ltd. [1917] A.C. 227.

14. Tobacco Manufacturers Committee v. Jacob Green & Sons 1953 (3) S.A. 480 (A.D.), per van den Heever J.A. at p. 492.

15. Bridge v. Campbell Discount Co. Ltd. [1962] A.C. 600, 622.

16. [1915] A.C. 79, 86: "This doctrine may be said to be found passim in nearly every case."

they say".[17] If this suggests that there is a presumption arising from the words used we doubt whether this is supported in the cases,[18] but the draftsman of a contract might be well advised not to use the word "penalty" just in case he might influence a court adversely. Be that as it may, in everyday speech most people - including lawyers - often talk of a "penalty clause" to mean a provision for payment of a stipulated sum which may be upheld as liquidated damages or struck down as a penalty. A reference to an enforceable penalty, then, although strictly inaccurate, is convenient in the absence of any other phrase to comprehend both types of clause, accords with Continental terminology, and is easily understood. To avoid a lengthy circumlocution we shall in this paper talk of "penalty clauses" to include enforceable (or arguably enforceable) and unenforceable provisions, and no presumption that a "penalty clause" is unenforceable will arise unless the context so requires.

10. The use of penalty clauses is extensive. Such clauses may be carefully drafted with a view to ensuring their validity when judged by Lord Dunedin's propositions.[19] A familiar example of a valid penalty clause is the demurrage which the charterer of a vessel agrees to pay as liquidated damages for detention of the ship for loading or unloading beyond the lay-days.[20] Penalty clauses are frequently embodied in building contracts to provide for the compensation payable for delay in

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17. Ibid.; Lord Elphinstone v. Monkland Iron & Coal Co. Ltd. (1886) 11 App. Cas. 332, 347, per Lord FitzGerald.

18. McGregor on Damages (13th ed., 1972), para. 338.

19. On the other hand, a clause which is well-known to constitute an unenforceable penalty may be recognised as such and ignored: see Wall v. Rederiaktiebolaget Luggude [1915] 3 K.B. 66, 74, per Bailhache J.

20. However, a clause in a charterparty providing "Penalty for non-performance of this agreement estimated amount of freight" is regarded as an unenforceable penalty: Wall v. Rederiaktiebolaget Luggude [1915] 3 K.B. 66; see also Leeds Shipping Co. Ltd. v. Société Française Bunge [1957] 2 Lloyd's Rep. 153; [1958] 2 Lloyd's Rep. 127.

completion[21] and, as minimum payment provisions, are a common feature of hire-purchase agreements. The Dunlop Tyre case[22] itself was an example of a valid penalty clause supporting a resale price maintenance agreement. Another example of the use of such clauses is in provisions intended to ensure that an employee on whose training substantial sums have been expended by the employer shall continue to serve his employer for a specified period after completion of training.[23] Penalty clauses are also commonly encountered in contracts with governments and public authorities[24] who in the event of breach will suffer damage which it will be very difficult to quantify.

11. There is little current[25] legislation on penalty clauses as opposed to provisions which enlarge or restrict the measure of damages itself.[26] Section 15 of the Agricultural Holdings Act 1948 provides:

> "Notwithstanding any provision in a contract of tenancy of an agricultrual holding making the tenant thereof liable to pay a higher rent or

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21. Thus the R.I.B.A. standard forms of building contract contain a clause on "damages for non-completion" providing: "If the contractor fails to complete the works by the date for completion ... and the architect ... certifies in writing that in his opinion the same ought reasonably so to have been completed, then the contractor shall pay or allow to the employer a sum calculated at the rate stated ... as liquidated and ascertained damages for the period during which the works shall so remain or have remained incomplete...."

22. [1915] A.C. 79.

23. In A-G for British Guiana v. Serrao (1965) 7 W.I.R. 404, the defendant was sent abroad by the British Guiana Government for telecommunications training; he undertook, if required, to serve the Government for five years and to repay the expenses of his course if he failed to do so. After serving for three and a half years he resigned. He was held liable to repay the expenses of the course.

24. C. Turpin, Government Contracts (1972), pp. 232-3.

25. The relevant provisions of the Administration of Justice Act 1696 and the Administration of Justice Act 1705, which dealt with penal bonds, have been repealed.

26. The Landlord and Tenant Act 1927, s. 18, restricts damages for breach of a repairing covenant in a lease to the amount by which the breach has diminished the value of the reversion.

other liquidated damages in the event of a breach or non-fulfilment of a term or condition of the contract, the landlord shall not be entitled to recover in consequence of any such breach or non-fulfilment, by distress or otherwise, any sum in excess of the damage actually suffered by him in consequence thereof."

Before the introduction of successive statutory provisions such as this it was not uncommon for agricultural tenancies to fix increased rents or provide for a specified sum of damages for various breaches of covenant such as breaking up pasture, altering the system of cultivation, felling timber or burning heather.[27] The 1948 section went further than earlier provisions which contained various exceptions to the now absolute rule that only the amount of the actual damage suffered can be recovered. This provision may be contrasted with eighteenth-century statutes providing for the recovery of double the yearly value of the land from a tenant who wilfully holds over after the expiry of a term of years,[28] and double rent from a tenant who holds over after terminating his tenancy by notice.[29] We do not propose to discuss such statutory provisions in this paper.

12. The distinction between a penalty and liquidated damages is mainly important in cases in which the amount specified is payable on breach of contract. There are several other types of provisions which to some extent resemble penalty clauses either in their commercial purpose or in their legal nature. In many cases the difference between a clause which will be regarded as an invalid attempt to impose a penalty and one which will be upheld as, for example, providing for no more than the price stipulated for exercising a contractual right, is slender and may turn on the exact words employed by the parties. In Gilbert-Ash (Northern) Ltd. v. Modern Engineering (Bristol) Ltd.

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27. See Muir Watt, Agricultural Holdings (12th ed., 1967), pp. 42-43.

28. Landlord and Tenant Act 1730, s. 1.

29. Distress for Rent Act 1737, s. 18.

30. [1973] 3 W.L.R. 421.

a provision in a building sub-contract by which the head contractor was entitled to withhold payment of any monies due to the sub-contractor if he failed to comply with any condition of the contract was said by four members of the House of Lords[31] to be a penalty and therefore unenforceable. On the other hand a clause providing that the contract price is only due when the works agreed upon have been "duly executed in accordance with this agreement" is in principle valid[32] and if the works have not been so executed nothing will be due, unless the doctrine of substantial performance applies.[33] The forfeiture of a deposit is another situation closely resembling the imposition of a penalty to which the law regarding relief against penalties does not as such apply.[34]

13. An acceleration clause providing for payment by instalments and for the whole sum unpaid to become payable on default in the payment of one instalment will not involve consideration of whether the sum claimed is an irrecoverable penalty if it is only to be classed as the contract price due under the contract.[35] Acceleration provisions are commonly found in instalment mortgages,[36] such as those in common use by building societies which provide for the repayment of the principal sum lent together with interest by equal instalments spread over a period of years subject to the proviso that on default the whole principal debt shall become immediately payable. Acceleration clauses also figure in certain types of short-term or second mortgages.[37]

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31. Lords Reid, Morris of Borth-y-Gest, Dilhorne and Salmon.

32. Eshelby v. Federated European Bank Ltd. [1932] 1 K.B. 423.

33. H. Dakin & Co. Ltd. v. Lee [1916] 1 K.B. 566.

34. Linggi Plantations Ltd. v. Jagatheesan [1972] 1 M.L.J. 89 (P.C.). See Part V, below.

35. White and Carter (Councils) Ltd. v. McGregor [1962] A.C. 413.

36. Wallingford v. Mutual Society (1880) 5 App. Cas. 685.

37. Report of the Committee on the Enforcement of Judgment Debts (1969, Cmnd. 3909), paras. 1352-1357. See Administration of Justice Act 1970, s. 36, and Administration of Justice Act 1973, s. 8.

Whereas a clause in a contract providing for reduction of the amount due on punctual payment or other performance, e.g., despatch money, is not subject to the law on penalties, an increase in the amount because of late payment is.[38]

14. Although it is probable that relief against a penalty is only available when the sum concerned is due on breach of contract,[39] the distinction between such sums and those for which no relief can be claimed may be a narrow one and it may be open to the parties, by adopting an appropriate formulation of their agreement, to produce one result rather than another. Thus, what would be objectionable if expressed as a penalty for delay might be perfectly validly achieved if expressed, with appropriate adjustment of the main terms of the contract and of the date for completion, as a bonus for early execution of the obligation.

15. The power to relieve against penalties is clearly an exception to the traditional view that, where there is no disability on either side, the court will not rewrite the contract which the parties have been content to make for themselves. Historically there is "a good deal of disagreement" as to how the penalty jurisprudence grew up.[40] One factor in the development of the power was the relief given in relation to penal bonds.[41] Such a bond consisted of an absolute promise to pay a stated sum of money with a condition providing that if some specified obligation was duly performed the promise to pay the money became void. Penal bonds are now rarely if ever encountere

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38. Wallingford v. Mutual Society (1880) 5 App. Cas. 685, 702; Wallis v. Smith (1882) 21 Ch.D. 243, 260.

39. The validity of this proposition is discussed in Part III, below.

40. Widnes Foundry (1925) Ltd. v. Cellulose Acetate Silk Co. Ltd [1931] 2 K.B. 393, 405 per Scrutton L.J.

41. The historical development is outlined by Bailhache J. in Wall v. Rederiaktiebolaget Luggude [1915] 3 K.B. 66, 72-3; and see A.W.B. Simpson, "The Penal Bond with Conditional Defeasance" (1966) 82 L.Q.R. 392.

in England.[42] Recent cases, particularly arising from hire-purchase agreements,[43] raise the question whether the court is restricted to granting relief from a penalty payable on breach of contract or whether this relief is merely an example of a wider and more general relieving jurisdiction. In support of the latter view it is pointed out that penal bonds themselves are not cases in which the sum in respect of which relief is sought is payable on breach of contract because there is an absolute obligation to pay it.[44] However, some judges favour a restriction of the power to grant relief to penalties payable on breach of contract, and deny that there is any wider principle enabling the court "to dissolve contracts which are thought to be harsh, or which have turned out to be disadvantageous to one of the parties".[45]

16. In the light of the broad survey of the existing law in the preceding paragraphs we have concluded that there are three main areas of the law which need investigation, and we shall deal with them in the succeeding parts of this working paper. In Part III we shall examine the question whether relief should be available when the penal sum is payable otherwise than on breach of contract; in Part IV we shall consider several aspects of the present law relating to penalty clauses; and in Part V we shall deal with the forfeiture of deposits and other sums paid.

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42. The form of administration bond set out in the First Schedule to the Non-Contentious Probate Rules 1954 (S.I. 1954 No. 796), required the obligation to be for double the gross value of the estate, unless otherwise directed. Administration bonds are no longer required: Administration of Estates Act 1971, s. 8.

43. See below, paras. 19 et seq.

44. Bridge v. Campbell Discount Co. Ltd. [1962] A.C. 600, 630-1, per Lord Denning.

45. Campbell Discount Co. Ltd. v. Bridge [1961] 1 Q.B. 445, 459, per Harman L.J.

PART III - SUMS PAYABLE OTHERWISE THAN ON BREACH OF CONTRACT

17. In the present law, before a sum due can be struck down as an invalid penalty there must be a breach of contract.[46] Thus, if a sum of money is payable on an event other than a breach of contract it is not open to the courts to hold that the sum is a penalty. This distinction between sums payable on breach and sums payable otherwise than on breach has emerged in a number of hire-purchase cases which will be referred to below, but it could arise in other types of agreement.[47]

18. The distinction just described could arise in any contract which entitled one contracting party to perform in alternative ways. For example, a contract to clean the windows of a house might be drawn in one of two ways:

(a) it might provide that "X hereby agrees to clean the windows on January 1 and in default of so doing to pay Y the sum of £100 as liquidated damages for the breach"

or (b) it might provide that "X hereby agrees to clean the windows on January 1 or, at his option, to pay Y the sum of £100

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46. Campbell Discount Co. Ltd. v. Bridge [1961] 1 Q.B. 445, 455, per Holroyd Pearce L.J. The point is perhaps open in the House of Lords: see para. 20, below. In Granor Finance Ltd. v. Liquidator of Eastore Ltd. 1974 S.L.T. 296 it was held that in Scotland the law about penalty and liquidated damages has no application except in cases involving breach of contract.

47. Indeed, it has arisen in cases on leases: Legh v. Lillie (1860) 6 H. & N. 165, especially per Wilde B. at p. 173; Moss' Empires Ltd. v. Olympia (Liverpool) Ltd. [1939] A.C. 544 (H.L.); and see Alder v. Moore [1961] 2 Q.B. 57.

instead, and X shall be taken to have exercised his option to pay the £100 if he does not clean the windows on January 1."

Existing authority clearly lays down that the contract in form (a) entitles the court to decide whether the sum of £100 is truly liquidated damages or is an unenforceable penalty, but suggests[48] that in form (b) if X neither cleans the windows nor pays the £100 he is not in breach of any obligation to clean the windows; his only breach would be in respect of his promise to pay £100 and provided there was consideration for this promise he could be sued for the £100, the court having no power to grant relief. This example is deliberately an extreme one, but seems to follow from the authorities.

19. The hire-purchase cases where this issue has arisen have centred on the "minimum payment clause" to be found in hire-purchase agreements. This is a clause requiring the hirer to pay a sum of money (often described as "compensation for depreciation") if the hiring comes to an end otherwise than by payment of the full hire-purchase price. The minimum payment clause may come into operation in a number of different ways, namely -

(i) on voluntary termination of the agreement by the hirer pursuant to a power conferred on him by the agreement;[49]

(ii) on termination of the agreement as the result of an event which does not involve

48. Moss' Empires Ltd. v. Olympia (Liverpool) Ltd. [1939] A.C. 544, especially per Lord Porter at pp. 558-9; and see below.

49. See for example the form set out in R.M. Goode, Hire-Purchase Law and Practice (2nd ed., 1970), App. E, Form 18 (p. 1160).

the exercise of an option to terminate nor a breach of contract;[50]

(iii) on automatic termination of the agreement as a result of the hirer's breach of contract;[51]

(iv) on termination of the agreement by the owner as a result of the hirer's breach of contract.[52]

20. The present law seems to be that in cases (i) and (ii) in paragraph 19, above, no question of penalty can arise; in case (i) this has the authority of the Court of Appeal,[53] in case (ii) that of the High Court.[54] In logical argument, they also have the support of a unanimous House of Lords in two cases.[55] A similar conclusion has been reached in Northern Ireland.[56] Cases (iii) and (iv) in paragraph 19 both involve

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50. Such as death or bankruptcy or winding-up.

51. See for example the form of hire-purchase agreement set out in R.M. Goode, op. cit., App. E. Form 2 (p. 1102). Cf. A.G. Guest, The Law of Hire-Purchase (1966), App. C, Form 5 (p. 620).

52. See the forms referred to in the preceding footnote.

53. Campbell Discount Co. Ltd. v. Bridge [1961] 1 Q.B. 445; see also Elsey & Co. Ltd. v. Hyde, Divisional Court, 1926 (unreported): see Jones and Proudfoot, Notes on Hire-Purchas Law (2nd ed., 1937), p. 107, at p. 112; cited with approval by Simonds J. in In re Apex Supply Co. Ltd. [1942] Ch. 108, 116; and Associated Distributors Ltd. v. Hall [1938] 2 K.B. 83, 88, per Slesser L.J.

54. In re Apex Supply Co. Ltd. [1942] Ch. 108.

55. Moss' Empires Ltd. v. Olympia (Liverpool) Ltd. [1939] A.C. 544, especially at pp. 551 and 558; Tool Manufacturing Co. Ltd. v. Tungsten Electric Co. Ltd. [1955] 1 W.L.R. 761, 767.

56. Lombank Ltd. v. Kennedy and Whitelaw [1961] N.I. 192 (C.A.); M.P. Furmston, "Ternmination of Hire Purchase Contracts: Minimum Payments and Penalties" (1964) 15 N.I.L.Q. 235. In Bridge v. Campbell Discount Co. Ltd. [1962] A.C. 600, 631, Lord Denning expressed agreement with the dissenting judgment of Lord MacDermott C.J.

termination on the hirer's breach of contract. They have been stated separately because of a suggestion in the cases[57] that there is a distinction between damages for breach of contract and a claim for money due on termination resulting from a breach of contract. We share the view of Hodson L.J., who said "My difficulty is to see the validity of the distinction between a claim to receive payment of a sum of money because of a right to determine arising from breach of contract and a claim to receive payment of the same sum by reason of breach of contract giving a right to determine".[58] In any event, they may now be treated together for the law is clear that, when the minimum payment clause comes into operation in these circumstances, it can be struck down as a penalty.[59]

21. Several judges have drawn attention to the paradox that exists in the present law. "It has been pointed out quite rightly to us", said Harman L.J.,[60] "that it is unsatisfactory if the man who honestly admits to the finance company that he cannot go on may have to pay a penalty, but that if he waits for the finance company to exercise their rights and in the meanwhile breaks the contract, he may be able to escape paying it on the ground that penalty for breach of contract is not enforceable in law." Lord Denning put it more tersely: "It means that equity commits itself to this absurd paradox: it will grant relief to a man who breaks his contract but will penalise the man who keeps it."[61] Lord Denning found himself able to reject this paradox by holding that equity could grant relief even without breach, but Harman L.J., though "oppressed" by the paradox, took the contrary view: "I do not therefore see my way to call in aid

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57. Notably by Salter J. in Elsey & Co. Ltd. v. Hyde, note 53, above.

58. Cooden Engineering Co. Ltd. v. Stanford [1953] 1 Q.B. 86, 116.

59. Cooden Engineering Co. Ltd. v. Stanford, above, approved in Bridge v. Campbell Discount Co. Ltd. [1962] A.C. 600 (H.L.).

60. Campbell Discount Co. Ltd. v. Bridge [1961] 1 Q.B. 445, 458.

61. Bridge v. Campbell Discount Co. Ltd. [1962] A.C. 600, 629.

equity to mend what may be an unfortunate situation and one which, if it calls for remedy, calls for aid by the legislature rather than by the justiciary."[62]

22. Our provisional view is that the court should have the power to deal with such clauses in the same way whether or not they come into operation by breach. There is however a problem of some difficulty, and that centres on the statutory description of contractual provisions to which this power will apply, since we do not envisage the power being confined to minimum payment clauses in hire-purchase agreements.[63] It would not, we think, be possible to confer such a power in relation to all contractual provisions calling for payment of a sum of money for it is not our intention that every price payable under a contract should be subject to judicial control.

23. As a preliminary, it may be helpful to look at the way in which those judges who have thought there was at present a power to regulate penalty clauses in these circumstances have justified their views. In Lombank Ltd. v. Kennedy and Whitelaw[64] Lord MacDermott C.J., dissenting, held that a penal minimum payment clause in a hire-purchase agreement need not be enforced even when it operated as the result of termination of the agreement by the hirer. His first ground for so deciding was that the hirer in question terminated the contract after breach of his promise to pay the instalments punctually and that the only feature distinguishing the case from Cooden Engineering Co. Ltd. v. Stanford[65] was "the merest technicality", namely that in

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62. Campbell Discount Co. Ltd. v. Bridge [1961] 1 Q.B. 445, 459. To the like effect is Black L.J. in Lombank Ltd. v. Kennedy and Whitelaw [1961] N.I. 192, 215.

63. So far as hire-purchase transactions are concerned the matter is already to some extent dealt with in sections 27 and 28 of the Hire-Purchase Act 1965. (See also sections 99 and 100 of the Consumer Credit Act 1974, which will come into operation on a day to be appointed.)

64. [1961] N.I. 192, 207.

65. [1953] 1 Q.B. 86.

the case before him it was the hirer who gave the terminating notice when the owners might equally well have done so: whether the hirer or the owners gave notice "there is the same non-performance and the same stipulation for payment of compensation". His second ground was that the rule against penalties applied where there was a breach of a contractual obligation whether or not the non-performance was actionable in itself. "The kind of stipulation struck at by the rule is one which seeks to enforce performance by a sanction out of proportion to the loss suffered by the promisee through non-performance. If the contract is so drawn as to make the non-performance not in itself an actionable breach the mischief which the rule seeks to control may not be any less."[66] He continued: "In either case the essential question is surely the same - is the relevant stipulation calculated to secure the performance of the hiring?"[67]

24. In Bridge v. Campbell Discount Co. Ltd.[68] Lord Denning based his view on the proposition that "From the very earliest times equity has relieved not only against penalties for breach of contract, but also against penalties for non-performance of a condition." He instanced the intervention of equity in relation to penalty bonds,[69] which did not necessarily contain any covenant to perform the condition and so involved no breach of contract for which the promisor could be sued for damages. Lord Devlin, in the same case,[70] reached a similar conclusion in a different way. The decision that the clause in question was a penalty when it came into operation as the result of a breach meant, he thought, that it contained no genuine estimate of the loss caused to the owner by depreciation and no genuine

66. [1961] N.I. 192, 207.
67. Ibid., emphasis in original.
68. [1962] A.C. 600, 629-631.
69. See para. 15, above.
70. [1962] A.C. 600, 633.

agreement that a sum should be paid in respect of it. "I do not see", he said, "how an agreement can be genuine for one purpose and a sham for another", and therefore if it must be ignored on a breach of contract it must be ignored if there was no breach.

25. The South African Conventional Penalties Act 1962 equates stipulations which provide that a party is to remain liable for the performance of some obligation upon withdrawal from an agreement with stipulations for penalties or liquidated damages.[71] A provision on these lines might deal with clauses which come into operation on a voluntary termination of an agreement, but we think that the phrase "upon withdrawal from an agreement" is too narrow to cover all the circumstances in which penalty clauses might come into operation.

Proposal for reform

26. A more acceptable approach would, we think, be this. There are in essence two separate matters which are being considered. There is first the contractual obligation which is being challenged as penal - typically (though not necessarily) an obligation to pay money in specified circumstances. Such an obligation might arise, for example, on the non-performance of some other act, or on the termination of an agreement voluntarily or on death or bankruptcy. The second matter is the act or result which is the true purpose of the contract, although its non-performance or non-fulfilment may not constitute a breach of the contract. Our proposal is that the rules as to penalties should be applied wherever the object of the disputed contractual obligation is to secure the act or result which is th

71. Act No. 15 of 1962, as amended by Act No. 102 of 1967. On the Act, see P.M.A. Hunt in [1962] Annual Survey of South African Law, p. 94 and C.I. Belcher, (1964) 81 S.A.L.J. 80. See also B.A. Hepple, (1961) 78 S.A.L.J. 445 on the Bill which led to the Act.

true purpose of the contract.[72] If, for example, a building contract were to provide for completion of the building by a certain date unless delayed by bad weather there would be no breach of contract if completion were delayed by bad weather. If the contract were also to provide that the builder should pay £50 for every day's delay caused by bad weather, the recoverability of the specified sum would depend on its being a genuine pre-estimate of the loss caused by delay. We should welcome views on this provisional proposal.

PART IV - DISCUSSION OF PENALTY CLAUSES GENERALLY

27. Before we come to a detailed look at some aspects of the present law of penalty clauses we ought to say that we have considered whether a radical change in the law should be canvassed. Broadly speaking there are, we think, four possible approaches to penalty clauses:

(i) that they should all be enforced in accordance with their tenor without any judicial control;

(ii) that none should be enforced;

(iii) that they should be enforced if reasonable at the time of contracting;

(iv) that they should be enforced if reasonable in the light of all the circumstances including the actual breach and its consequences.

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72. Cf. Sloman v. Walter (1783) 1 Bro. C.C. 418, 419 per Lord Thurlow L.C. : "where a penalty is inserted merely to secure the enjoyment of a collateral object, the enjoyment of the object is considered as the principal intent of the deed, and the penalty only as accessional, and, therefore, only to secure the damage really incurred...."; and Shiloh Spinners Ltd. v. Harding [1973] A.C. 691, 723, per Lord Wilberforce: "where the primary object of the bargain is to secure a stated result...."

28. We do not think that there is any case at all for supporting the first possibility: indeed, our provisional proposal[73] that the law on penalties should be applied to cases where there is no breach of contract indicates our view that some control over penalty clauses is needed. There is certainly something to be said for the second possibility: if it were felt that the policy of the law should be that, while the parties themselves create the obligation, the law prescribes the consequences of breach, then that policy would be implemented best by never enforcing any penalty clause, however reasonable. But the advantages of penalty clauses are not all on one side and there are practical considerations which favour the retention of the possibility of valid penalty clauses. As Diplock L.J. said in Robophone Facilities Ltd. v. Blank,[74]

> "the courts would be doing an ill favour to those whom the rule about 'penalty clauses' is designed to protect if they were to apply it so as to make it impracticable for parties to agree at the time when they enter into a contract upon a fair and easily ascertainable sum to become payable by one party to another as compensation for the loss which the latter will sustain as a consequence of its breach. It is good business sense that parties to a contract should know what will be the financial consequences to them of a breach on their part, for circumstances may arise when further performance of the contract may involve them in loss. And the more difficult it is likely to be to prove and assess the loss which a party will suffer in the event of a breach, the greater the advantages to both parties of fixing by the terms of the contract itself an easily ascertainable sum to be paid in that event. Not only does it enable the parties to know in advance what their position will be if a breach occurs and so avoid litigation at all, but if litigation cannot be avoided, it eliminates what may be the very heavy legal costs of proving the loss actually

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73. See para. 26, above.

74. [1966] 1 W.L.R. 1428, 1447. See, too, Kemble v. Farran (1829) 6 Bing. 141, 148, per Tindal C.J.

sustained which would have to be paid by the unsuccessful party.[75] The court should not be astute to descry a 'penalty clause' in every provision of a contract which stipulates a sum to be payable by one party to the other in the event of a breach by the former."

29. The third possibility is not far removed from the present law: whether the penalty clause is enforced depends on whether the sum to be paid was, at the time of contracting, a genuine estimate of the likely consequences of breach. If it was a genuine pre-estimate then this, we think, comes to much the same thing as saying that it was reasonable.[76] The fourth possibility would judge whether the sum payable was reasonable, not in the light only of circumstances as they appeared at the time of contracting likely to be, but also in the light of the circumstances as they really are at the time of the trial. This is, broadly, the approach taken in South Africa if the penalty is found to be "out of proportion to the prejudice suffered"[77] and is not dissimilar to that in some Continental countries.[78]

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75. We may add here that another procedural advantage is that a speedier and cheaper final judgment can be obtained in default of appearance or defence, or under R.S.C., O. 14, if the action is for a liquidated sum rather than for unliquidated damages. In the county court, a claim for a liquidated amount must be brought by default action: C.C.R., O.6, r. 2(1).

76. In its 1973 Recommendation on Liquidated Damages, the California Law Revision Commission proposed that a "contractual stipulation of damages should be valid unless found to be unreasonable.... Reasonableness should be judged in light of the circumstances confronting the parties at the time of the making of the contract and not by the judgment of hindsight. To permit consideration of the damages actually suffered would defeat one of the purposes of liquidated damages, which is to avoid litigation of the amount of actual damages" (p. 1209).

77. Conventional Penalties Act 1962, s. 3 (South Africa); see above, note 71.

78. This information is derived from the Unidroit Study referred to in para. 5, above.

30. Although there may be some support for the fourth possibility, we do not ourselves favour it. It seems to us that to judge the validity of a penalty clause by reference to circumstances as they exist after the breach would mean the introduction of an unacceptable amount of uncertainty. We realise that a possible objection to the present law is that circumstances may arise where the penalty clause is enforceable because it was a genuine pre-estimate, but as things turn out the loss suffered is negligible so that the stipulated sum exceeds the loss to a disproportionate extent. We consider this possibility in more detail below, but our present view is that this objection does not justify a radical change in the present law. However, as the fourth possibility is an approach which may be canvassed by some States in the discussion of penalty clauses at Strasbourg[79] we should nevertheless welcome opinions about it.

31. We now turn to look at some aspects of the present law in more detail.

(i) Stipulated sum disproportionate to loss

32. We have already mentioned the principle that a clause is classed as providing for a penalty or liquidated damages in th light of all the circumstances "judged of as at the time of the making of the contract, not as at the time of the breach".[80] Even if the sum stipulated for was a genuine pre-estimate of damage at the time the contract was entered into, it is possible to hold the view that it is inappropriate that the court should enforce the stipulation where the effect would be to give the party entitled to the benefit of the penalty clause a sum very much larger than the loss he has in fact suffered. The larger the margin by which the agreed sum exceeds the loss, the more

79. See para. 5, above.

80. Dunlop Tyre case [1915] A.C. 79, proposition 3 in Lord Dunedin's formulation of principles: see para. 7, above.

reasonable it appears that it should be possible to avoid applying a penalty clause despite its being a reasonable but (as it turns out) mistakenly generous assessment which should be upheld.

33. If a contract attempts to secure the advantages of a valid penalty clause it cannot in many cases be anything more than an intelligent guess at what loss would probably be suffered in future circumstances unforeseen in detail. This is particularly so in the case of contracts with governments and local authorities whose loss in many cases will be very difficult to quantify.[81] It should not, therefore, be an objection to a penalty clause that the amount payable is not precisely the sum which a court would award as damages in the events that have occurred, unless the whole idea of permitting such clauses is opposed or their use is to be restricted to cases in which the court will have great difficulty in assessing damages[82] and the parties' pre-estimate cannot therefore positively be shown to be wrong.

34. Nevertheless, circumstances may arise where a penalty clause, valid under the tests propounded by Lord Dunedin, requires payment of a sum quite clearly unrelated to any loss actually suffered. This is because the question of construction that determines whether a clause is to be rejected as an invalid penalty is decided upon the circumstances "judged of as at the time of the making of the contract, not as at the time of the breach." It is not difficult to imagine cases where the amount payable under a penalty clause, though not "extravagant,

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81. See proposition 4(d) in Lord Dunedin's formulation.

82. Cf. the American Law Institute's Restatement of the Law of Contracts, s. 339(1). This provides that one of the situations in which an agreement fixing damages in advance of breach of contract shall be enforceable is where "the harm that is caused by the breach is one that is incapable or very difficult of accurate estimation."

exorbitant or unconscionable"[83] at the time of the contract, would clearly be out of proportion to the loss actually suffered. If a contract for the sale of goods provides for liquidated damages to be paid on failure to make due delivery of the goods, the clause may represent a perfectly genuine attempt by the parties to estimate the loss. If, however, at the time of breach similar goods can in fact be purchased in the market either at the contract price or at a lower price the victim of the breach will have suffered no damage or only trifling loss. A more complicated example would involve separate contracts including penalty clauses with A and B for the supply of different goods both of which are essential to the manufacture of a commodity by C. If either A or B broke his contract the consequences would be non-manufacture of C's commodity. If, however, both A and B break their contracts can each of the penalty clauses be enforced by C so that "damages" are in effect recovered twice over? Whether, in such circumstances, the penalty clause should still be allowed to apply depends to a large extent on whether the practical advantages of such clauses are thought to outweigh any objections to the parties making such bargains and, while freely allowed to agree on a price (which may be fair or unfair), being restricted in regard to specifying the consequences of breach of contract.

35. Despite the ease of imagining such cases, it is difficult to find any reported example in the English (or Scottish) courts of a case where the amount payable under a penalty clause, though not "extravagant, exorbitant or unconscionable" at the time of the contract, is clearly exorbitant in relation to the loss actually suffered. In the Clydebank Engineering case,[84] the Spanish Government had ordered four torpedo boats from Scottish shipbuilders during the Spanish-American war. The

83. Clydebank Engineering and Shipbuilding Co. Ltd. v. Don Jose Ramos Yzquierdo y Castaneda [1905] A.C. 6, 17, per Lord Davey.

84. [1905] A.C. 6.

contracts provided a "penalty" for late delivery at the rate of £500 per vessel per week. There were considerable delays in respect of which the Government claimed £67,500. One of the arguments advanced by the defenders to show that the payment was unenforceable was that after the delivery date the greater part of the Spanish fleet had been sunk in an engagement with the enemy. "If we had kept our contract and delivered these vessels," the defenders said, "they would have shared the fate of the other vessels ... in fact you have got your ships now, whereas if we had kept our contract they would have been at the bottom of the Atlantic."[85] Lord Halsbury L.C. dismissed this argument as utterly absurd without bothering to refute it in detail, but Lord Davey did hold that evidence of the damage actually suffered by the Spanish Government was "perfectly irrelevant and inadmissible", saying that "it was for the very purpose of excluding that kind of evidence" that the parties inserted the clause.[86] We see nothing objectionable in the result achieved by the House of Lords in this case. The case is a good example of the difficulty or impossibility of assessing damages for the breach of many contracts with governments or public authorities. So, delay in completing a new road may cause inconvenience to the public but no loss to the highway authority which has contracted for its construction. The loss caused by delay in constructing a non-profit-making warship may, as the Clydebank Engineering case shows, be very difficult to assess, compared with delay in completing a profit-making passenger or freight vessel. If there is a class of case, such as this, in which it is well-nigh impossible to assess the actual damage suffered then it follows that there are instances in which the court could no more judge a penalty clause by reference to the circumstances at the time of breach than by reference to those at the date of contract.

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85. As put by Lord Halsbury L.C., [1905] A.C. 6, 13.
86. [1905] A.C. 6, 17.

36. If, as Lord Davey says, a penalty clause operates to exclude evidence of the damage actually suffered, then the court is only concerned to examine the position as it appeared to the parties when they entered into the contract: in other words, "the question whether [the stipulation] is exorbitant or unconscionable is to be considered with reference to the point of time at which the stipulation is made between the parties."[87] If, judged from this standpoint, the clause is not exorbitant it must, presumably, be enforced like any other contractual obligation even if, in the events which have happened, the victim of the breach thereby reaps an unexpected advantage. The question is whether such an advantage need be regarded as unjust any more than any other unexpected profit reaped from an agreement, for example, by reason of a change in market prices, is to be regarded as unjust.

37. There may, in the existing law, be some reluctance on the part of the courts to construe contracts in such a way that a breach can result in the recovery of a stipulated sum which is disproportionately high in relation to the loss actually suffered. The court will inevitably know what breach has occurred and may consequently have some idea of what actual damage has been suffered and, despite the approach approved by Lord Davey, it is unlikely to be able wholly to ignore the position with reference to the point of time at which the stipulation is broken. In Webster v. Bosanquet,[88] a clause providing for liquidated damages on failure to sell to the plaintiff "the whole or any part of the crop" of the defendants' tea estates was upheld in relation to a sale of 53,000 lbs. of tea, and Lord Mersey said "The parties to the agreement were merchants using language in the sense in which it is used in their trade. When they speak of a 'part of a crop' they are not contemplating packets which might be sold over a grocer's counter, but parcels such as

87. Forrest & Barr v. Henderson, Coulborn & Co. (1869) 8 M. 187, 193, per Lord President Inglis.

88. [1912] A.C. 394 (P.C.).

were in fact sold in the present case."[89] This may be thought to look very much like judging the validity of the clause by reference to the circumstances at the time of breach. It can, therefore, be argued that the courts already have some regard to the circumstances as they exist at the time of breach or even, perhaps, at the time of trial.

38. The sort of difficulty a court may get into by taking too literally the exhortation to have regard to the circumstances at the time of making the contract and not to have regard to those at the time of the breach is illustrated by a dictum in a Zanzibar case[90] which was decided as if English law applied. A contract for the sale of 75 chests of drawers stipulated that for every day of default in delivery the seller should pay £5. This clause was upheld and the agreed sum was awarded when the seller delivered only 25 chests and delivery by the agreed date fell short by 50 chests. The judge observed: "It is true that it might have fallen short by only one chest of drawers, but that, to my mind, does not alter the fact that the sum stipulated to be paid is payable on a single event only, namely, non-completion of the entire contract."[91] £5 a day might conceivably have been a genuine pre-estimate of the loss to be suffered on non-delivery of one chest, but the reasoning of the judge would apply equally if the sum was a genuine pre-estimate of the loss for non-delivery of 75 chests and the loss for delay in delivery of one chest would be pre-estimated at a trifling sum.

39. Contracts, such as that in the Zanzibar case, which require payment of a stipulated sum for every day, or other period, of default may to a limited extent require the court to pay regard to what has occurred since breach. Although the

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89. Ibid., at p. 398.

90. Mistry Popat Mulji v. Lewis, Paton & Co. (1950) 8 Z.L.R. 230.

91. Ibid., at p. 235

point does not seem to have been raised in any case, there must presumably be a limit to the period for which such a clause can continue to multiply the daily liquidated sum. It would not, we think have been open to the buyer in the Zanzibar case, if the supplier had decided never to supply the outstanding chests of drawers, to wait indefinitely (perhaps to the eve of the end of the period of limitation) and then sue for an enormous sum calculated at the daily rate since breach some years previously. Perhaps this problem would be solved by construing the penalty clause as applying only to delay and not to a breach that amounted to total or partial non-performance.

40. In the United States cases can be found which demonstrate that, without having to admit speculative evidence, the existence of an alarming discrepancy between the stipulated sum and the actual loss is not a remote possibility. A striking example is Massman Construction Co. v. City Council of Greenville, Mississippi,[92] where the City Council employed the construction company to build piers for a new toll-bridge over the Mississippi River. The contract provided for liquidated damages of 250 dollar per day for delay. The work was completed 96 days late for reasons beyond the fault of the construction company, and the Council retained some 24,000 dollars from the price as liquidated damages. However, the bridge was finished at least 30 days before it could be used because the road leading to it on one side of the river had not been completed by the State authorities building it. Thus it was argued that the construction company's breach caused no delay in operating the bridge and no loss to the Council. The court refused to enforce the provision in question as a penalty. We doubt whether this case would be so decided by an English court as the approach adopted by the American court seems to depart from that enunciated by Lord Davey in the Clydebank Engineering case[93] with its emphasis on viewing circumstances at

92. 147 F. 2d 925 (1945) (Circuit Court of Appeals, Fifth Circuit).

93. [1905] A.C. 6.

the time the contract is made. Although, perhaps, at first sight the result in the Massman case may seem not unreasonable, suppose the bridge (and the road) were completed a day late and on the day when completion was to have taken place there was a government prohibition on driving petrol-fuelled vehicles so that the bridge owners would not have received the tolls which they might otherwise have expected. To allow such extraneous considerations to determine the validity of a penalty clause would, we think, go far to make such clauses of little practical use. Other illustrations can be found in American cases,[94] though some can be explained on the ground that the clause should have been held to be unenforceable in the light of the circumstances at the time the contract was made. The United States Supreme Court seems to prefer to test the validity of a penalty clause by considering the position at the time the contract was made.[95]

41. We have formed the clear view that the test based on the circumstances at the time of making the contract has, on the whole, worked satisfactorily. Opinions may differ as to whether the enforcement of a penalty clause on facts such as

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94. For example, in Northwest Fixture Co. v. Kilbourne & Clark Co., 128 F. 256 (1904), liquidated damages were claimed against the estate of a bankrupt company, the company on its insolvency having failed to transfer its assets to the plaintiffs as agreed. The Circuit Court of Appeals stated that "It is the general rule that, where the sum named in the contract to be paid on a breach thereof is evidently wholly disproportionate to the damage actually sustained, or where it is shown that no actual damage has been sustained by the breach, the courts will deem the parties to have intended to stipulate for a mere penalty to secure performance" (p. 261). It is, however, clear that an English court would have no difficulty in finding that a clause requiring a contracting party to pay 10,000 dollars as liquidated damages for any breach of such a contract was an invalid penalty under accepted principles.

95. Wise v. United States 249 U.S. 362 (1919); Priebe & Sons Inc. v. United States 332 U.S. 407 (1947).

those in the Massman case[96] is unjust, and the result of the Clydebank Engineering case[97] is, as we have said above,[98] in our view, unobjectionable. The fact that in certain circumstances a party to a contract might derive a benefit in excess of his loss[99] does not seem to us to outweigh the very definite practical advantages of the present rule upholding a genuine estimate, formed at the time the contract was made, of the probable loss. We recognise that there are arguments in favour of empowering the court to refuse to enforce a liquidated damages clause if the agreed sum is clearly disproportionate to the amount of loss but our provisional conclusion is that this power would produce intolerable uncertainty, particularly in commercial cases.

(ii) The "loss" which is to be estimated

42. Penalty clauses are particularly valuable in cases in which it is likely to be difficult for the plaintiff's loss to be assessed. However, in cases in which a fairly accurate assessment of loss would be praticable, are the parties to the contract restricted to making a genuine pre-estimate of the damages which the court would award in an action if there were no penalty clause or can they agree that the loss which will be suffered on a breach of contract should be calculated on some other basis? Could they, to adopt the words of Asquith L.J. in Victoria Laundry (Windsor) Ltd. v. Newman Industries Ltd.,[100] provide for "a complete indemnity of all loss de facto resulting from a particular breach, however improbable, however unpredictable"? In cases of breach of contract the aggrieved

96. 147 F. 2d 925 (1945).

97. [1905] A.C. 6.

98. Para. 35, above.

99. We have found no demonstrable example of this in the English cases.

100. [1949] 2 K.B. 528, 539.

party who sues for damages in "only entitled to recover such part of the loss actually resulting as was at the time of the contract reasonably foreseeable as liable to result from the breach".[101] Can the parties stipulate for and thus, in effect, make foreseeable, damages on a scale more extensive than the court could otherwise award? There would seem to be no reason why the parties in Hadley v. Baxendale[102] could not have contracted for liquidated damages assessed on the footing that the mill would continue to be at a standstill, or those in the Victoria Laundry case[103] for the loss of profit on the lucrative government contract. Such a clause would, perhaps, have been doing no more than expressly invoking the so-called second rule in Hadley v. Baxendale. It may be, however, that the parties should be able to go even further and provide not merely for loss which is foreseeable in the light of their knowledge at the time of entering into the contract but also for loss directly resulting from the breach even if a court would, in a case in which there was no express provision for liquidated damages, regard such loss as unforeseeable or as irrecoverable for some other reason, for example, because of failure to mitigate the loss suffered or by reason of the incidence of taxation.[104]

43. Diplock L.J. discussed this aspect of penalty clauses in Robophone Facilities Ltd. v. Blank:[105]

> "The onus of showing that [a stipulation for payment of a sum in the event of breach of contract] is a 'penalty clause' lies upon the party who is sued upon it. The terms of the clause may themselves be sufficient to give rise to the inference that it is not a genuine estimate of damage likely to be suffered but is a penalty. Terms which give rise to such an inference are discussed in Lord Dunedin's speech in Dunlop Pneumatic Tyre Co. v. New Garage and Motor Co. Ltd.[106] But it is

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101. Ibid.
102. (1854) 9 Exch. 341.
103. [1949] 2 K.B. 528.
104. Beach v. Reed Corrugated Cases Ltd. [1956] 1 W.L.R. 807
105. [1966] 1 W.L.R. 1428, 1447-8.
106. [1915] A.C. 79, 87.

an inference only and may be rebutted. Thus it may seem at first sight that the stipulated sum is extravagantly greater than any loss which is liable to result from the breach in the ordinary course of things, i.e., the damages recoverable under the so-called 'first rule' in Hadley v. Baxendale.[107] This would give rise to the prima facie inference that the stipulated sum was a penalty. But the plaintiff may be able to show that owing to special circumstances outside 'the ordinary course of things' a breach in those special circumstances would be liable to cause him a greater loss of which the stipulated sum does represent a genuine estimate. In the absence of any special clause in the contract, this enhanced loss due to the existence of such special circumstances would not be recoverable at common law from the defendant as damages for the breach under the so-called 'second rule' in Hadley v. Baxendale unless knowledge of the special circumstances had been brought home to the defendant at the time of the contract in such a way as to give rise to the inference that the defendant impliedly undertook to bear any special loss referable to a breach in those special circumstances: see Asquith L.J.'s explanation of British Columbia Saw Mill Co. v. Nettleship[108] contained in Victoria Laundry (Windsor) Ltd. v. Newman Industries Ltd.[109]

"The basis of the defendant's liability for the enhanced loss under the 'second rule' in Hadley v. Baxendale is his implied undertaking to the plaintiff to bear it.... But such an undertaking need not be left to implication; it can be express .... And so if at the time of the contract the plaintiff informs the defendant that his loss in the event of a particular breach is likely to be £x by describing this sum as liquidated damages in the terms of his offer to contract, and the defendant expressly undertakes to pay £x to the plaintiff in the event of such breach, the clause which contains the stipulation is not a 'penalty clause' unless £x is not a genuine and reasonable estimate by the plaintiff of the loss which he will in fact be likely to sustain.[110] Such a clause is in my view enforceable whether or not the defendant knows what are the special circumstances which make the loss likely to be £x rather than some lesser sum which it would be likely to be in the ordinary course of things."

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107. (1854) 9 Exch. 341.

108. (1868) L.R. 3 C.P. 499.

109. [1949] 2 K.B. 528, 538.

110. "obtain" in original.

44. The extent to which the parties to a contract should be free to go beyond invoking the "special circumstances" rule, and apply to the measurement of the loss caused by breach a yardstick which the court would not use, is a question on which we should value views. Our provisional view is that the proper yardstick by reference to which it should be determined whether the stipulated sum is a genuine pre-estimate is the damages which a court would award. If a party wishes to ensure that he can recover compensation for a loss in excess of recoverable damage he should do so by an express provision, not by a penalty clause; so, too, if he wishes to intimate the existence of "special circumstances" to the other party he should not simply rely on a provision for a high stipulated sum.

45. In certain types of transaction there may be a series of penalty clauses. This is likely to occur where there is sub-contracting under a main contract. If the main contractor may be liable to pay liquidated damages resulting from a failure which is likely to be due to the default of a sub-contractor, it is natural for him to attempt to cover himself against this liability and he may seek to do so by inserting in his contract with the sub-contractor either a clause embodying the penalty clause of the head contract by reference,[111] or an express provision for the payment of liquidated damages calculated in the same way as in the head contract. In the Zanzibar case referred to above,[112] the defendants, who were claiming to enforce a penalty clause against the plaintiff, had placed the contract with the plaintiff in part fulfilment of a contract they had made with the Overseas Food Corporation. The head contract fixed a time limit for its performance and stipulated that the defendants should be liable to a penalty of £5 per day (the same sum as in the sub-contract) for each

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111. See Corrigan Company Mechanical Contractors v. Fleischer 423 S.W. 2d 209 (Missouri, 1968).

112. Mistry Popat Mulji v. Lewis, Paton & Co. (1950) 8 Z.L.R. 230; para. 38 above.

day's delay. In circumstances such as these, there may seem, at first sight, to be a great deal to be said on grounds of convenience for allowing the enforcement of a penalty clause in the sub-contract without entering into an examination of the situation relating to the corresponding clause in the head contract. But in our view it would constitute too great an abdication of the court's power of review to give automatic effect to a penalty clause in a sub-contract merely because it reflects the corresponding clause in the head contract. There appears to be no English authority on this point, but our provisional view is that if it can be shown that the clause in the head contract is one which would be enforced then there should be a presumption that the clause in the sub-contract is also valid.

(iii) Stipulated sums as upper limits[113]

46. If a genuine pre-estimate of loss turns out to be wrong and the loss actually suffered is less than the liquidated sum, the stipulated sum is nevertheless recoverable. But it also follows that if the stipulated sum is less than the actual loss it is the stipulated sum that is recoverable, not the actual loss.[114] In these circumstances the stipulated sum in fact operates as a limitation of liability. On the other hand, if the stipulated sum is an invalid penalty it is ignored, and if the actual loss is greater than the penal sum the actual loss is recoverable.[115] This is capable of

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113. See A.H. Hudson, "Penalties Limiting Damages" (1974) 90 L.Q.R. 31.

114. Cellulose Acetate Silk Co. Ltd. v. Widnes Foundry (1925) Ltd. [1933] A.C. 20.

115. Wall v. Rederiaktiebolaget Luggude [1915] 3 K.B. 66, approved in Watts, Watts and Co. Ltd. v. Mitsui and Co. Lt [1917] A.C. 227. In the Cellulose Acetate case [1933] A.C 20, 26, Lord Atkin said: "I desire to leave open the ques tion whether, where a penalty is plainly less in amount than the prospective damages, there is any legal objection to suing on it, or in a suitable case ignoring it and suin for damages." And cf. Hudson loc. cit., and G.H. Gordon, (1974) 90 L.Q.R. 296.

leading to a paradoxical situation where the party who put in an agreed damages clause for his own benefit finds that the stipulated sum is too low in the events that have occurred and that he would be in a better position if it were an invalid penalty.

47. Before proceeding to comment on this aspect of the law, there is a preliminary point to be made. In so far as a contractual provision operates as a limitation of remedies it may be regarded as exempting the party who benefits (the prospective defendant) from what would otherwise be his full liability and may therefore be regarded as an exemption clause. Penalty clauses operating in this way fall within the scope of the study which we and the Scottish Law Commission have been conducting into exemption clauses in contracts and we assume that any legislation which may be enacted relating to exemption clauses might apply to this aspect of penalty clauses.

48. When the loss actually suffered exceeds the agreed amount odd consequences may follow if the amount is a "penalty" and not "liquidated damages". "The essence of a penalty is a payment of money stipulated as in terrorem of the offending party".[116] Yet here the party said to be "terrorized" by the clause benefits from and seeks to uphold it. The court is supposed to decide whether the clause is a penalty by reference to the circumstances as at the time the contract was made, yet striking down the clause because it appeared to penalise the party in breach at the earlier time will be to his disadvantage at the later time because instead of only having to pay the agreed sum he will be liable for the full amount of damage suffered by the party who sought to impose the invalid penalty.[117] We should welcome views on whether in this situation it should (subject to any legislation dealing with exemption clauses) be open to the party suing for breach of contract to show that the

116. Dunlop Tyre case [1915] A.C. 79, 86, per Lord Dunedin.

117. See generally W.F. Fritz, "'Underliquidated' Damages as Limitation of Liability" (1954) 33 Texas L. Rev. 196.

loss he has sustained exceeds the amount of the stipulated sum even if that is held not to have been a genuine pre-estimate of damage.

PART V - FORFEITURE OF MONIES PAID

49. There is much in common between the problems which need consideration when a deposit or part payment is forfeited on a breach of contract and when an action is brought on a provision requiring a payment on a breach or termination.[118] The latter provision may be either liquidated damages or a penalty, and this we have already discussed. The forfeiture of money paid (or which ought to have been paid) before the breach has however been treated very differently by the courts. The essential differences between a deposit and a penalty are that one is due, and usually paid, in advance while the other is only payable after breach or termination, and that on payment of the deposit the parties contemplate that the contract will be performed, while the penalty clause contemplates that it might not be performed. The similarity in their effect, however, makes it desirable for us to examine the forfeiture of monies paid in the same paper as penalty clauses.

(i) The present position

50. In the present law the general principle in cases of sale has been said to be that if the seller treats the contract as at an end owing to the buyer's default, the buyer is entitled to recover money handed over in part payment of the purchase price, subject to a cross-claim by the seller for damages.[119]

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118. See Part III, above, for money payable under penalty clauses otherwise than on breach of contract.

119. Stockloser v. Johnson [1954] 1 Q.B. 476, 489, per Denning L.J.; Dies v. British and International Mining and Finance Corporation Ltd. [1939] 1 K.B. 724, 743, per Stable J.

But if the contract contains an express[120] forfeiture clause, or if the money is expressly[120] paid as a deposit (which is usually treated as implying a forfeiture clause), the money is not recoverable unless equity relieves against forfeiture.[121] Thus the principle we are now considering applies not only to money which is described as a "deposit" but also to money paid or payable in respect of or on account of the purchase price (whether or not by instalments) where there is a provision for forfeiture on breach of contract. It will however be convenient to refer shortly to such sums as deposits in the following paragraphs. We are not in this paper concerned with the right to provide in a contract for the payment of a deposit but solely with the question whether the money can be retained.

51. Deposits are used in a variety of circumstances. In contracts of sale they range from a sum of money paid to a shopkeeper as a deposit on placing an order[122] to the familiar ten per cent deposit paid by a purchaser of land on exchange of contracts.[123] In contracts of hire a deposit may be payable by the hirer before the goods are delivered. No doubt there are many other situations in which deposits are paid, with or without an express forfeiture clause. In the sale of goods, the price may be payable by instalments which are to be forfeited on default.[124] In the sale of land it appears that in recent years houses have been sold subject to the payment of

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120. Perhaps it need not be expressly stated: Gallagher v. Shilcock [1949] 2 K.B. 765, 769, per Finnemore J.

121. Stockloser v. Johnson [1954] 1 Q.B. 476, 490, per Denning L.J.

122. Elson v. Prices Tailors Ltd. [1963] 1 W.L.R. 287.

123. See, e.g., The Law Society's General Conditions of Sale (1973 Revision) conditions 5(1) and 19(4); National Conditions of Sale (18th ed., 1969), condition 22(3). There is no need to discuss here a deposit paid before exchange of contracts since it will be repayable if no contract is entered into.

124. See the Hire-Purchase Act 1965 and the Consumer Credit Act 1974 as to conditional sale agreements (defined in s. 1(1) of the 1965 Act and s. 189(1) of the 1974 Act).

the price by instalments, with forfeiture of the instalments and eviction of the purchasers on default, in order to avoid the Rent Acts.[125]

52. There are several different reasons why a deposit or down payment may be sought. A deposit demonstrates the payer's serious intentions in relation to the transaction. It shows his willingness and ability to raise at least some of the money ultimately to be required of him, and helps to guard against the consequences of his possible insolvency. It may be required by economic legislation.[126] Most important, it serves to secure the recipient against a breach of contract; as Fry L.J. said in Howe v. Smith[127] a deposit "is not merely a part payment, but is ... also an earnest to bind the bargain so entered into, and creates by the fear of its forfeiture a motive in the payer to perform the rest of the contract."

53. It will be seen that, like a penalty clause, a deposit can be regarded as operating in terrorem.[128] Yet the courts do not seem to regard this as a reason why its forfeiture should not be upheld. Nor does the amount of a deposit necessarily bear any relation to the loss that a breach of contract might cause to the party not in breach: the ten per cent deposit on the sale of land is an arbitrary amount[129] and

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125. Report of the Committee on the Rent Acts (the Francis Committee) (1971, Cmnd. 4609), p. 112; B.M. Hoggett, "Hous on the Never-Never: Some Legal Aspects of Rental Purchase" (1972) 36 Conv. (N.S.) 325. Such agreements may be conditional sale agreements as defined in s. 189(1) of the Consumer Credit Act 1974.

126. Currently, the Hire-Purchase and Credit Sale Agreements (Co trol) Order 1973, S.I. 1973 No. 2129, as amended, and the Control of Hiring Order 1973, S.I. 1973 No. 2130, as amende

127. (1884) 27 Ch.D. 89, 101; similarly Bowen L.J. described it as "according to the ordinary interpretation of business me a security for the completion of the purchase": ibid., p. See too Myton Ltd. v. Schwab-Morris [1974] 1 W.L.R. 331, 3 per Goulding J.

128. See para. 8, above.

129. It "represents pure practice and is never even a perfuncto pre-estimate": J.T. Farrand, Contract and Conveyance (2nd ed., 1973), p. 264.

can be retained by the vendor on the purchaser's breach even if he suffers no loss - indeed, even if he makes a profit on a resale and, because the market price of houses is rising, it was foreseeable when the original contract was made that he would do so.[130] Since the forfeiture of a deposit does not prevent the vendor from suing for damages (giving credit for the amount forfeited) if he suffers further loss, he appears thus to get the best of both worlds.[131] Yet, subject to equity's power to grant relief, to which we return below,[132] it has been said that an order for the forfeiture of a deposit is "one which is to be made ex debito justitiae ... I do not see how the court can hesitate for a moment in giving the plaintiff what he asks."[133]

54. Equitable relief against forfeiture of a deposit is, however, available, though there is much uncertainty as to the circumstances in which it will be granted and to what extent the relief may involve the return of money as distinct from giving a defaulting party more time to perform the contract.[134] As Lord Hailsham of St. Marylebone L.C. pointed out in a recent case,[135] the last word has not yet been spoken on this subject. In Stockloser v. Johnson[136] an instalment contract for the sale of plant and machinery provided that if the purchaser defaulted in payment of an instalment the vendor should be entitled to rescind the contract, forfeit all the instalments paid, and retake possession of the goods. The majority of the Court of

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130. Condition 19(4)(c) in The Law Society's General Conditions of Sale (1973 Revision), confirming the general law, expressly provides that any surplus on a resale shall be retained by the vendor.

131. Contrast the position where the amount payable under a valid liquidated damages clause is less than the loss suffered: paras. 46-48, above.

132. See paras. 54 and 55.

133. John Barker & Co. Ltd. v. Littman [1941] Ch. 405, 412, per Clauson L.J.

134. See Galbraith v. Mitchenall Estates Ltd. [1965] 2 Q.B. 473.

135. Linggi Plantations Ltd. v. Jagatheesan [1972] 1 M.L.J. 89, 94 (P.C.).

136. [1954] 1 Q.B. 476.

Appeal[137] held that the court has jurisdiction to relieve against forfeiture of instalments after rescission if in the actual circumstances it would be unconscionable for the vendor to retain the instalments. Relief could be given even if there was no sharp practice or fraud on the part of the vendor and although the purchaser was not able to find the balance due (so that the equitable relief is not merely confined to allowing the purchaser more time). Denning L.J. formulated the conditions in which equity can relieve a buyer from forfeiture of a deposit (or other sums representing part payment and liable to forfeiture) and order the seller to repay it on such terms as the court thinks fit: "Two things are necessary: first, the forfeiture clause must be of a penal nature, in this sense, that the sum forfeited must be out of all proportion to the damage, and, secondly, it must be unconscionable for the seller to retain the money."[138] As an example he instanced a deposit and part payment not of the usual ten per cent but of fifty per cent and suggested that where the vendor resold the property at a profit the court would relieve against the forfeiture. What is not very clear is what, in this context, will amount to unconscionable conduct. As the deposit must be of a penal nature it might be thought that a reference to unconscionable conduct was necessarily implied without more but it would seem that what is, perhaps, intended is that the penal element is to be judged as at the time of making the contract whereas any elements of unconscionability are to be assessed at the time when the equitable relief is sought.

55. Romer L.J., in the same case, whilst agreeing that jurisdiction to relieve against forfeiture exists in an appropriate case, thought that the court's powers were more circumscribed: "there is no sufficient ground for interfering with the contractual rights of a vendor under forfeiture clauses of the nature which are now under consideration, while the contract is still subsisting, beyond giving a purchaser who is in default

137. Somervell and Denning L.JJ.

138. [1954] 1 Q.B. 476, 490.

but who is able and willing to proceed with the contract, a further opportunity of doing so; and no relief of any other nature can properly be given, in the absence of some special circumstances such as fraud, sharp practice or other unconscionable conduct of the vendor, to a purchaser after the vendor has rescinded the contract."[139]

56. Mention must also be made of section 49 of the Law of Property Act 1925, which provides as follows:

> "(2) Where the court refuses to grant specific performance of a contract, or in any action for the return of a deposit, the court may, if it thinks fit, order the repayment of any deposit.
>
> (3) This section applies to a contract for the sale or exchange of any interest in land."

Before this provision came into force a person who refused to complete a contract for the purchase of land might defeat the vendor's action for specific performance on equitable grounds such as unfairness, hardship or mistake but still be liable at law to have his deposit forfeited.[140] Section 49(2) cured this unsatisfactory situation by allowing the court to order the return of the deposit wherever it was shown that the vendor's action for specific performance had failed or would

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139. Ibid., p. 501. Relief in the form of successive extensions of time is possible: Starside Properties Ltd. v. Mustapha [1974] 1 W.L.R. 816 (C.A.). The defendant agreed to buy a house from the plaintiffs and to pay part of the purchase price (described as a deposit) by monthly instalments. On default of payment of any instalment the vendors were to be entitled to rescind the contract and forfeit all sums paid by way of deposit. The county court judge held this to be a penalty, a holding approved by Edmund Davies L.J. at p. 819. See Hoggett, "Relief for Rental Purchasers-Equity Beats Parliament by a Short Head?" (1974) 37 M.L.R. 705, and Fairest, "Equitable Relief against Penalties" [1974] C.L.J. 209.

140. In re Scott and Alvarez's Contract [1895] 2 Ch. 603; Beyfus v. Lodge [1925] Ch. 350.

have failed if brought, but it may have done no more.[141] It is therefore doubtful whether a purchaser can recover his deposit under section 49(2) if he has no legal or equitable grounds for failing to complete the purchase. It will be noted that the section only applies to the sale or exchange of interests in land and that the court is allowed no middle way; either the whole deposit must be returned or nothing.

(ii) Discussion of the law

57. Although it is undoubtedly true that "the law relating to the forfeiture of deposits has always been treated as entirely distinct and separate from the learning introduced into English law by the distinction between liquidated damages ... and a penalty",[142] it is not easy to see why, apart from the greater antiquity of the law relating to the giving of "earnest",[143] the two concepts should not be treated similarly. In the Campbell Discount case[144] Lord Radcliffe said:

> "I know, of course, that, to travel to another branch of equity's relief jurisdiction, the precise reason why a deposit made on a sale of land is not recoverable if the bargain goes off by the purchaser's default is that it is treated as a guarantee ...; but nevertheless every penalty, even a penal bond, is in some sense a guarantee for the due performance of the contract, and I do not see any sufficient reason why in the right setting a sum of money

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141. Williams, Vendor and Purchaser (4th ed., 1936), pp. 30-31, cited with approval by Vaisey J. in James Macara Ltd. v. Barclay [1944] 2 All E.R. 31, 32 (affirmed on other grounds [1945] K.B. 148). See, however, Megarry J. in Schindler v. Pigault, The Times, 22 January 1975.

142. Linggi Plantations Ltd. v. Jagatheesan [1972] 1 M.L.J. 89, 91.

143. The history was surveyed by Fry L.J. in Howe v. Smith (1884) 27 Ch.D. 89, 101-102.

144. Bridge v. Campbell Discount Co. Ltd. [1962] A.C. 600, 624.

> may not be treated as a penalty, even though it arises from an obligation that is essentially a guarantee."[145]

Again, Lord Hailsham of St. Marylebone L.C. has emphasised that the refusal of equitable relief assumes the deposit or earnest to be reasonable:

> "It is ... no doubt possible that in a particular contract the parties may use language normally appropriate to deposits properly so-called and even to forfeiture which turn out on investigation to be purely colourable and that in such a case the real nature of the transaction might turn out to be the imposition of a penalty, by purporting to render forfeit something which is in truth part payment. This no doubt explains why in some cases the irrecoverable nature of a deposit is qualified by the insertion of the adjective 'reasonable' before the noun."[146]

58. The substantial difference between a deposit liable to forfeiture and a sum due as liquidated damages or as a penalty is that payment of the former was made or due before any breach of contract occurred. This leads to distinctions both legal and practical. The legal distinction is referred to in Stockloser v. Johnson[147] where Denning L.J. described a penalty in terms of a party exacting "payment of an extravagant sum either by action at law or by appropriating to

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145. For other suggestions that the distinction is unsound see McGregor on Damages (13th ed., 1972), para. 385 ("A penalty should be a penalty still whether it be a sum payable or a sum retainable, and the courts should afford relief from both"); J.T. Farrand, Contract and Conveyance (2nd ed., 1973), pp. 263-265.

146. Linggi Plantations Ltd. v. Jagatheesan [1972] 1 M.L.J. 89, 94. In an Indian case, apparently approved by the Privy Council in the Linggi Plantations case, a distinction was drawn between payment of a sum of Rs. 1,000, held to be a forfeitable deposit, and payment of a further sum of Rs. 24,000, also said to be forfeitable on breach, which was held "not of the nature of earnest money" and not subject to forfeiture: Fateh Chand v. Balkishan Das [1964] 1 S.C.R. 515.

147. [1954] 1 Q.B. 476, 488-9; emphasis added.

himself moneys belonging to the other party".[148] A deposit, or payments on account of the purchase price, on the other hand, are said to differ in that the money belongs to the recipient absolutely as soon as it is paid. "He only wants to keep money which already belongs to him." The practical distinction is that a party paying a deposit is likely to be far more conscious of the fact that he is at risk if he defaults; and that he may not see his money again than if he merely agrees to pay a sum of money in the future on what he may regard as a remote and unlikely contingency.

59. We are not persuaded that these distinctions justify the radically different treatment which the law affords to the two concepts. There may be something in the practical distinction we have just mentioned, but the question whether a party agreeing to pay a penal sum knew and understood exactly what he was assenting to at the time of the contract has never been regarded as relevant to support the enforcement of a penalty. The legal distinction seems to break down when one considers that a deposit does not cease to be forfeitable simply because it has not yet been paid. In Hinton v. Sparkes[149] the vendor, whose loss on resale after the first purchaser's default was £10, sued to recover £50 due from the purchaser as a deposit but never in fact paid. The court, after saying that had the contract provided for payment of the £50 as liquidated damages it would have been held to be a penalty, enforced the agreement to pay the money as a deposit: the money was due on the making of the contract, and the vendor should not be at a disadvantage because the money was not in fact paid when it should have been: "I cannot see why the rights of the vendor should be affected by the purchaser's having committed two breaches of contract instead of one."[150] Perhaps in one sense

148. As in Commissioner of Public Works v. Hills [1906] A.C. 368.

149. (1868) L.R. 3 C.P. 161.

150. Ibid., per Willes J. at p. 166. This case was not cited to Pennycuick J. in Lowe v. Hope [1970] Ch. 94. It is not thought that the presence of an I.O.U. for £50 in Hinton v. Sparkes would justify a distinction between these cases, any more than would the giving of a cheque, subsequently dishonoured, for the deposit.

the unpaid £50 "already belonged" to the vendor, but this is only because the court upheld the vendor's claim. By way of contrast money held by the vendor cannot be treated as subject to forfeiture if it "belongs" to the purchaser in the sense that the purchaser has a valid claim to it in the absence of any right to forfeiture.[151]

60. Since the exact nature of the court's jurisdiction to grant relief is uncertain the question arises whether the position should be clarified and, if so, whether the distinction between penalties and deposits should be reduced or eradicated. It is not necessary to go to the extreme, rejected by Harman L.J.[152] and Lord Simonds,[153] of a general principle which justifies the court in relieving a party to any bargain if, in the event, it operates hardly against him.

(iii) Proposals for reform

61. In our view the law needs reconsideration. There are four possible courses which could be adopted with regard to the forfeiture of deposits and other sums paid:

(i) the power to relieve against forfeiture could be abolished;

(ii) the power could be limited to giving more time to perform the contract;[154]

(iii) it could extend both to giving more time and to the repayment of money or the return of property;[155] or

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151. Retention monies were said to be penalties in Commissioner of Public Works v. Hills [1906] A.C. 368 and Gilbert-Ash (Northern) Ltd. v. Modern Engineering (Bristol) Ltd. [1973] 3 W.L.R. 421 (H.L.), among other cases.

152. Campbell Discount Co. Ltd. v. Bridge [1961] 1 Q.B. 445, 459.

153. Bridge v. Campbell Discount Co. Ltd. [1962] A.C. 600, 614.

154. Cf. Romer L.J. in Stockloser v. Johnson [1954] 1 Q.B. 476, 501: see para. 55, above.

155. Cf. the majority in the Court of Appeal in Stockloser v. Johnson [1954] 1 Q.B. 476: see para. 54, above.

(iv) the distinction for present purposes between payments made before breach and agreements to pay money after breach could be abolished, thus assimilating the law on forfeiture of deposits to that on liquidated damages and penalties.

62. We do not consider that any case worth considering can be made for the first course and it seems to us self-evident that there must be circumstances in which it would be intolerable if the court had no power whatsoever to relieve against an obviously oppressive forfeiture.

63. The second possibility would be no more than to affirm that relief against forfeiture is limited to giving a party in default a further opportunity of performing his obligations under the contract. This modest relieving power has the greatest attraction in relation to land transactions where in many cases the only relief which the defaulting buyer may require is more time either to raise the money he owes or to find someone to whom he can re-sell the property so that he can use the proceeds to pay off his own vendor.[156] In some circumstances a mere time-giving power would also suffice in relation to sales of goods, particularly where nothing is likely to turn on movements of market prices. Such cases would, however, be comparatively infrequent and in other transactions a mere power to allow a longer period to pay would be inappropriate and provide no satisfactory solution. Thus in the case of the deposit paid for a package holiday on which the purchaser finds himself unable to proceed, he will derive no benefit from being given longer to pay for what he no longer wants. To allow time for payment in a simple hiring where the amount due will increase so long as the contract is kept on foot would not seem productive of a satisfactory result. In cases such as these the most appropriate

156. As in Starside Properties Ltd. v. Mustapha [1974] 1 W.L.R. 816.

relief would necessarily involve a consideration of the deposit or part-payment and of the question whether the party in breach should be allowed to claim back some or all of it (with a set-off for the actual damage incurred by the other party). In our view, therefore, except perhaps in relation to transactions concerning land,[157] a power limited to giving more time would not be adequate.

64. We accordingly turn to consider the third possible course, which would be to confer a general power on the court to grant such relief as the court considers just, whether by allowing more time to perform or by ordering the return of all or part of money or property which has been forfeited or is subject to forfeiture. The principles on which the court should act in exercising this power, particularly in relation to the return of money or property, might perhaps follow those formulated[158] by Denning L.J. - that the forfeiture clause must be of a penal nature (in the sense that the amount forfeited is out of all proportion to the damage) and that it must be unconscionable for the money to be retained. But we see no great advantage in having two different criteria. If the penal nature of the clause itself is not to be sufficient to entitle the court to intervene, our provisional view is that it would be simpler and more straightforward to empower the court to relieve against forfeiture if it was reasonable to do so, regard being had to -

(a) the general practice in transactions of a similar nature, particularly as to the amount of deposits payable; and

(b) the reasonableness of the sum in amount, bearing in mind the loss which a breach of contract might cause but testing this as it would have appeared to the parties at the time the contract was made (although

157. See para. 66, below.

158. In Stockloser v. Johnson [1954] 1 Q.B. 476, 490: see para. 54, above.

the fact that the sum was not related to loss would not in itself show that it was unreasonable); and

(c) all the circumstances of the case.

It would, we think, be necessary for the court to take into account the general practice as to the size of deposits, mentioned in (a) above, so that, for example, it could have regard to the normal practice in contracts for the sale of land,[159] but this could not be conclusive: merely because a trade association representing a particular branch of commerce recommended its members to seek a stated proportion of the price as a deposit, for example, should not preclude relief.

65. There would, we think, be definite advantages in giving the court the flexible power envisaged in the possible solution outlined in paragraph 64, but we are conscious that our objection to a similar power in relation to penalty clauses - that it would introduce an unacceptable amount of uncertainty into the law[160] - could equally be applied to this solution. We have therefore given some thought to the fourth possible solution[161] to see whether this might also enable the court to do justice while reducing uncertainty by adopting criteria which are already well established. Whether this would be the effect would, of course, depend on the views of those who comment on the discussion of the law, and possible reforms of the law, relating to penalty clauses contained in Part IV of this paper. On the assumption that the present way of treating penalty clauses is to remain, then the validity of a provision for forfeiture of a deposit would depend on whether

159. "... there is nothing unusual or extortionate in a 10% deposit on a contract for the sale of land": Linggi Plantations Ltd. v. Jagatheesan [1972] 1 M.L.J. 89, 93 per Lord Hailsham of St. Marylebone L.C.

160. See para. 30, above.

161. See para. 61(iv), above.

the amount of the deposit represented a "genuine pre-estimate" of the loss likely to be occasioned by a breach of contract. At the present time the size of a deposit is not, we believe, generally arrived at in this way: the truth is that deposits are usually arbitrary sums, seen not as potential compensation but as a complete or partial guarantee against breach and an inducement to perform. The introduction of the law as to penalties would, therefore, result in a radical change in the practice if there were not to be a wholesale invalidation of the right to forfeit deposits. Apart from transactions affecting land, this would, we think, be a desirable consequence. It is likely that many who pay deposits, such as the purchasers of cars, do not really appreciate the distinction between a deposit and a part-payment not subject to forfeiture and often imagine that the deposit is paid simply to show their serious intentions. They would contemplate that if the transaction proceeds the deposit represents payment of part of the price. It is unlikely they understand that if they resile the deposit is to be forfeited in cases where the seller suffers no loss.

66. Land transactions, however, stand on a somewhat different footing. The position with regard to the status of the deposit is probably better understood and in most cases the vendor and purchaser will be acting with legal advice. It may therefore be that deposits paid in connection with sales of land and houses merit special treatment. As we have already indicated[162] the existing power to allow the purchaser more time to complete may be valuable and adequate in many land transactions. We should not wish our provisional recommendations to be construed as excluding this form of relief in such cases. However there will inevitably be cases in which the giving of additional time will not be adequate to do justice between the parties and when relief against forfeiture by repayment of all or part of the deposit or part-payment will be proper. In such circumstances instead of possibility (iv) applying, we provisionally consider that a special rule might, on grounds of

162. Para. 63, above.

convenience, apply to land sales. Such a rule might provide that if the deposit does not exceed a statutorily specified percentage of the purchase price, it should be valid and subject to forfeiture. We are by no means convinced that at the present time ten per cent is the right figure and we are inclined to think that a lower figure, perhaps five per cent, would be preferable.[163] If a five per cent deposit were forfeited a vendor could still sue if he suffered a greater loss as a result of the breach of contract. Moreover a statutory limit on the percentage that might be forfeited without question would not prevent the parties agreeing on a higher figure, but this would be subject to attack as a penalty and would then have to be justified in the same way as a deposit on a transaction not relating to land. We should welcome views on the general merits of the proposal in this paragraph, and information and suggestions on the figure that would be most appropriate.

67. In paragraphs 64 and 65 we have canvassed what appear to us to be the two courses which might feasibly be adopted to provide a measure of judicial control over the forfeiture of deposits and other sums paid in cases not relating to land. Our provisional conclusion is in favour of the second, that is the application of the law regarding liquidated damages and penalties, but with a special rule for deposits on the sale of land, but we should be grateful for opinions about this preference. Although expanding the grounds on which forfeiture of a deposit can be challenged might at first sight seem likely to lead to a great deal of litigation we doubt whether this will necessarily be the result. It would, of course, take some time for commercial practice to adjust to a new rule. However, it must be borne in mind that as the person who stipulated for

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163. The California Law Revision Commission in its 1973 Recommendation on Liquidated Damages suggested that a five per cent deposit on a contract to purchase real property should be deemed to be valid.

a deposit will already be in possession of the money it will, unlike the case of a penalty payable after breach, be the party who has paid who will usually have to initiate the litigation. This he may be unlikely to do unless he considers he has strong grounds, but if the deposit is excessive judged by the tests referred to, it seems to us only just that it should be refunded, subject, of course, to a set-off for the damages actually suffered.

PART VI - SUMMARY OF PROPOSALS

68. We should welcome comments on any matters relevant to the subjects discussed in this paper, and in particular on the following points:

(a) Sums payable otherwise than on breach:

(i) Judicial control over penalty clauses should be possible even where the clause in question comes into operation without any breach of contract (paragraph 22).

(ii) The rules as to penalty clauses should apply where the object of the provision alleged to be penal is to secure the act or result which is the true purpose of the contract (paragraph 26).

(b) Penalty clauses generally:

(iii) There should be no radical change in the present law relating to penalty clauses. However, we should, for the purposes of the Council of Europe study of penalty clauses, welcome views on judging such clauses in the light of the damage actually suffered (paragraph 30).

(iv) The application of the tests to distinguish between valid and invalid penalties ("liquidated damages" and "penalties") in the light of the circumstances at the time the contract was made has, on the whole, worked satisfactorily (paragraph 41).

(v) The conferment of a power on the courts to refuse to enforce an otherwise valid provision for liquidated damages if the stipulated sum is excessive in relation to the loss actually occasioned would produce intolerable uncertainty, and such a power should not be introduced (paragraph 41).

(vi) The courts should test the genuineness of a pre-estimate of necessary compensation by reference to the damages which a court would be likely to award (judged from the viewpoint of the making of the contract) (paragraph 44).

(vii) In relation to sub-contracts, if it can be shown that a penalty clause in the head contract is one which would be enforced then there should be a presumption that a corresponding clause in the sub-contract is valid (paragraph 45).

(viii) Where the sum payable under a penalty clause is less than the loss actually sustained, should damages be limited to the stipulated sum, and should this depend on whether the stipulated sum was or was not a genuine pre-estimate? We should welcome views on this (paragraphs 46-48).

(c) Forfeiture of monies paid:

(ix) The court's jurisdiction to grant relief against the forfeiture of a deposit or part payment should be reconsidered (paragraph 61).

(x) We put forward for consideration two possible ways of dealing with relief against forfeiture in place of the present law (paragraph 67).

(xi) One way would be to confer a general power on the court to grant such relief as it considers just, whether by allowing more time to perform a contract or by the return of money or property. The court would be empowered to grant relief if it was reasonable to do so, regard being had to -

(1) the general practice in transactions of a similar nature, and

(2) the reasonableness of the amount which is subject to forfeiture, and

(3) all the circumstances of the case (paragraph 64).

(xii) The other way would be to apply to forfeiture the law regarding liquidated damages and penalties, but with a special rule applying to deposits on the sale of land (paragraphs 65 and 66).

(xiii) The special rule applying to deposits on the sale of land might enable the defaulting purchaser to challenge, on

the same principles as apply in other cases, the forfeiture of a deposit exceeding a statutory percentage of the purchase price. We should welcome views as to what this statutory percentage should be. The court should in all cases relating to land continue to have jurisdiction to extend the time for completion (paragraph 66).

(xiv) Our provisional conclusion is in favour of the proposals in paragraphs (xii) and (xiii) above, but we should welcome views on this preference (paragraph 67).

Printed in England for Her Majesty's Stationery Office by Product Support (Graphics) Limited, Derby
Dd 506990 K24 4/75